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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

TO THE

KOREA DEVELOPMENT FINANCE CORPORATION

WITH THE

GUARANTEE OF THE REPUBLIC OF KOREA

June 11, 1969

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A PROPOSED
LOAN TO THE KOREA DEVELOPMENT FINANCE CORPORATION
WITH THE GUARANTEE OF THE REPUBLIC OF KOREA

1. I submit the following report and recommendation on a proposed loan in an amount in various currencies equivalent to \$20 million to the Korea Development Finance Corporation (KDFC), to be guaranteed by the Republic of Korea.

PART I - HISTORICAL

2. The rapid industrialization of the Korean economy has created an unsatisfied demand for industrial finance on reasonable terms. KDFC was established in April 1967 with the assistance of the Bank Group to provide urgently needed long-term finance to the private sector. Its initial capitalization, including investments by IFC and foreign private investors and a loan of \$5 million from the Bank, was completed in February 1968. KDFC made its first investments in June 1968. The full amount of the first Bank loan is expected to be committed by the end of August 1969. The proposed \$20 million loan is expected to provide KDFC with sufficient foreign exchange resources to meet its projected commitments up to mid-1971.

3. Negotiations for the proposed loan were held in Washington between May 20 and 22, 1969. The Borrower, KDFC, was represented by its President, Mr. C.H. Kim. The Government was represented by Mr. K.S. Choi, Counselor, Korean Embassy, and Mr. J.Y. Sun, Third Secretary, Korean Embassy.

4. The proposed loan would be the third Bank loan to Korea, bringing the total amount of Bank lending to \$70 million. Korea has received four IDA credits for a total of \$43.2 million. In the next few months I expect to submit a recommendation for a Bank loan of about \$20 million for a third railway project which has recently been appraised.

5. The following is a summary statement of Bank loans and IDA credits to Korea as of May 31, 1969:

<u>Loan or Credit No.</u>	<u>Year</u>	<u>Borrower</u>	<u>Purpose</u>	<u>Amount (US \$ million)</u>		
				<u>Bank</u>	<u>IDA</u>	<u>Undisbursed</u>
25	1962	Republic of Korea	Railway		13.9	Nil
110	1967	Republic of Korea	2nd Railway		11.0	0.9
529	1968	KDFC	Industry	5.0		4.4
S-4	1968	Republic of Korea	Highway			
			Studies		3.5	2.9
600 <u>1/</u>	1969	ULIA	Irrigation	45.0		45.0
151 <u>1/</u>	1969	Republic of Korea	Education		<u>14.8</u>	<u>14.8</u>
Total (less cancellations) now outstanding				50.0	43.2	
Total undisbursed						<u>68.0</u>

1/ Not yet effective

6. The first railway project has been completed and the other projects are progressing satisfactorily. Disbursements are on schedule. IFC has invested \$700,000 in KDFC; an equity investment of about \$0.3 million and a \$1.4 million loan by IFC for a silk reeling project have been approved recently. IFC is considering a \$3.8 million investment in equity and loan to a paper mill.

PART II - DESCRIPTION OF THE PROPOSED LOAN

7.	<u>Borrower:</u>	Korea Development Finance Corporation (KDFC)
	<u>Guarantor:</u>	Republic of Korea
	<u>Amount:</u>	Various currencies equivalent to \$20 million
	<u>Purpose:</u>	To enable KDFC to finance the foreign exchange cost of specific projects undertaken by private industrial enterprises in Korea.
	<u>Amortization:</u>	The initial amortization schedule provides for repayment over 15 years, in semi-annual payments beginning November 15, 1971 and ending May 15, 1986, subject to change in order to conform substantially to the aggregate of amortization schedules for sub-loans and investments for which withdrawals from the loan account are made.
	<u>Interest Rate:</u>	6½ percent per annum

Commitment Charge: Three-fourths of one percent per annum

Prior Approval
of Projects: All loans for projects requiring more than \$300,000 in foreign exchange and all equity investments are subject to the Bank's prior approval. Loans for projects requiring less than \$300,000 would not require the Bank's prior approval subject to an aggregate limit of \$5 million.

PART III - THE PROJECT

8. A report entitled "Appraisal of Korea Development Finance Corporation" (DB-49a) dated June 5, 1969 is attached.

9. Manufacturing has been the driving force behind Korea's phenomenal economic growth; it accounted for nearly one-quarter of Korea's GNP and for two-thirds of Korea's total exports in 1968. The growth rate of manufacturing is considerably higher than the growth rate of any of the other sectors and amounted to almost 29% in 1968. During the last few years, capital goods industries have expanded more rapidly than consumer goods industries although the latter are still predominant. Large-scale enterprises with a labor force of more than 200 account for more than half of the manufacturing output. Manufacturing enterprises are predominantly privately owned.

10. This rapid expansion of the Korean economy has created a strong demand in the private industrial sector for medium-term and long-term finance, and especially for foreign exchange resources. Besides KDFC, the only financial institutions in Korea providing medium-term and long-term industrial finance are the Korean Reconstruction Bank and the Medium Industry Bank, both Government-owned. However, the Government has stated its intention that KDFC would be the principal source of industrial financing for the private sector. Over the past twelve months KDFC's operations have been gathering momentum and both the number and experience of its professional staff have been building up. There is a strong demand for its services, and there appears to be little doubt that it would be able to commit the proposed Bank loan of \$20 million within two years from July 1969.

11. When KDFC's financing was completed in February 1968, IFC made an equity investment in KDFC of won 192.5 million (\$702,000 equivalent at the exchange rate obtaining at that time) and KDFC received a loan from the Government of won 2,025 million (equivalent of US\$7.5 million at that time) in addition to loans from U.S. AID and the Bank of \$5 million each. KDFC at present has no other debt.

12. As of March 31, 1969, KDFC had access to total resources amounting to \$24.4 million equivalent. They consisted, at the present

rate of exchange, of share capital resources and retained earnings amounting to about \$7.2 million equivalent, the Government loan of \$7.2 million equivalent, and the two loans totalling \$10 million from the U.S. AID and the Bank.

13. As of June 5, 1969, KDFC's total commitments for loans, debentures and share investments amounted to \$5.8 million equivalent. Of that amount, commitments for foreign exchange loans amounted to \$3.6 million, of which \$0.5 million is to be drawn from the AID loan, and \$3.1 million from the first Bank loan.

14. KDFC is well managed and competently staffed. Sound procedures have been set up, the quality of KDFC's appraisals is good and, although its present portfolio is still small, the quality of KDFC's project supervision is of a high standard. In view of the prospective volume of business, the professional staff needs to be increased, and KDFC's management continues to recruit and train personnel.

15. KDFC's financial position is satisfactory. In 1967 and 1968 net income was derived almost entirely from interest on bank deposits awaiting disbursement against past and future commitments. Net income in 1967 and 1968 amounted to won 107 million (\$0.38 million) and won 436 million (\$1.56 million) respectively. KDFC has not yet paid a dividend and all earnings have been retained.

16. The first Bank loan to KDFC provided for the Bank's commitment fee to be charged only on amounts credited to the loan account, a concession that was made because KDFC was then a new institution. For the proposed loan the Bank's standard policy on commitment charge would be applied..

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

17. The draft Loan Agreement between the Bank and the Korean Development Finance Corporation, the draft Guarantee Agreement between the Republic of Korea and the Bank, the Report of the Committee provided for in Article III, Section 4(iii) of the Articles of Agreement and the text of a draft Resolution approving the proposed loan are being distributed to the Executive Directors separately.

18. The draft Loan and Guarantee Agreements conform substantially to the pattern of agreements for loans to development finance companies.

PART V - THE ECONOMY

19. The economic report entitled "The Current Economic Position and Prospects of the Republic of Korea" (EAP-4a) was circulated to the Executive Directors on March 19, 1969. Further updated information on

the performance of the Korean economy is contained in the "Report and Recommendation of the President to the Executive Directors on a proposed Credit to the Republic of Korea for an Education Project" (P-699), dated May 14, 1969, which was distributed to the Executive Directors on May 15, 1969.

20. The Korean economy continued its very rapid growth in 1968, when, based largely on expansion in the manufacturing sector, GNP increased by 13%. Exports continued their strong rising trend, particularly exports of manufactured goods which have increased by over 50% per annum in recent years. However, largely because of the high import component of Korea's manufactured products, imports also increased rapidly, and the deficit on goods and services account has continued to expand. Also, although gross domestic savings are increasing in relation to GNP, the portion of gross capital formation financed by external capital was over 40% in 1968 and is expected to increase further this year. A substantial portion of this is being met by short- and medium-term foreign debt and, while the debt service ratio was only 7.4% of exports of goods and services in 1968, it is likely to increase to 20% in 1970. The Korean authorities announced at the Consultative Group meeting in April their intention to impose stricter controls over the inflow of short- and medium-term capital and to limit service on medium- and long-term debt to 15% of foreign exchange earnings.

21. The Government intends to carry out a careful review of its investment program and has asked the Bank to help it re-examine a proposed steel project and to recommend the most economical and efficient way of meeting Korea's requirement for steel. Since the Government evidently desires to pursue sensible economic policies, and particularly to limit foreign borrowings to reasonable amounts, the underlying strength of the economy should result in the emergence of a satisfactory balance of payments position. Therefore, Korea can be regarded as credit-worthy for this loan, which will contribute to the further expansion of the vigorous manufacturing sector along sound and productive lines.

PART VI - COMPLIANCE WITH ARTICLES OF AGREEMENT

22. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank.

PART VII - RECOMMENDATION

23. I recommend that the Executive Directors approve the proposed loan.

Attachment

Robert S. McNamara
President

June 11, 1969